BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CHARLES R. RIETZ)

For Appellant: Charles R. Rietz,
in pro. per.

For Respondent: Michael E. **Brownell**
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Charles R. Rietz against proposed assessments of additional personal income tax and penalties in the total amounts of $31,815, **$32,887.50, $55,616.25, $38,168.16, $31,772.59,** and **$35,958.75** for the years 1973, 1974, 1975, 1976, 1977, and 1978, respectively.

The issues for determination are the following: (i) did appellant receive unreported income from the marketing and management of investments and tax shelters during the years at issue; (ii) if he did, did respondent properly reconstruct the amount of that income; and (iii) if so, were penalties for failure to file and failure to furnish information requested properly imposed?

As a result of a criminal investigation by the Contra Costa District Attorney's office of appellant for California securities law violations relating to the promotion and sale of various tax shelters and other investments, respondent learned that appellant and a number of entities promoted by him had not filed California tax returns for the years at issue nor reported any taxable income. Respondent's Special Investigations Unit began an extensive investigation of these entities, apparently with the view of bringing criminal tax evasion charges against appellant. Respondent attempted to obtain information concerning appellant's alleged tax evasion directly from appellant and by issuing administrative subpoenas upon banks with which his investment entities transacted business. Appellant was ultimately successful in quashing these subpoenas but, prior to such ultimate success, appellant sent many of the contested records to respondent. Because of appellant's success in quashing the subpoenas, respondent abandoned its investigation for criminal violations and, instead, initiated a civil tax investigation of appellant's financial affairs.

Respondent attempted to obtain additional information from appellant in order to reconstruct appellant's income during the years at issue. Since appellant apparently did not cooperate, respondent relied upon the information which it then had available, primarily from the criminal investigation, and upon public documents to reconstruct his income as follows:

1973	$202,000
1974	$208,508
1975	$346,250
1976	$241,765
1977	$201,743
1978	$229,065

In addition to the resulting tax assessments, respondent assessed penalties for failure to file returns as required and for failure to furnish information requested., Appellant protested these assessments and respondent's denial of that protest led to this appeal.

On appeal, appellant's only arguments are: (1) that respondent has failed to prove, prima facie, that appellant earned any income in any of the years at issue; and, (2) that appellant is unable to establish that he had no taxable income without incriminating himself in violation of the Fifth Amendment of the United States Constitution.

During the years at issue, appellant worked as a real estate salesman, insurance salesman, securities salesman, and commodities trader. As a result of the criminal investigation, respondent determined that appellant had substantial unreported taxable income during this period. Appellant has offered no explanation for the checks which he cashed or deposited in his own account or for the management fees which offering circulars attributed to him. His only contention appears to be that there is no evidence which would prove that such proceeds constituted taxable income to him. We have held in similar circumstances that appropriate evidence obtained from a criminal investigation may create a reasonable inference that a taxpayer received taxable income. (Appeal of Phillip and Winifred Purer, Cal. St. Bd. of Equal., Sept. 28, 1977.) Accordingly, since appellant bears the burden of proving to the contrary and since he has made no attempt to do so, we must find for respondent and hold that respondent has established a prima facie case that appellant had unreported income during the years at issue.

The second question presented then is whether respondent properly reconstructed the amount of appellant's income during the period at issue. The California Personal Income Tax Law requires a taxpayer to state specifically the items and amount of his gross income during the taxable year. Gross income includes all income from whatever source derived unless otherwise provided in the law. (Rev. & Tax. Code, § 17071.) Gross income includes compensation for services including fees and commissions. (Rev. & Tax. Code, § 17071, subd. (a)(l).) Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. (Treas. Reg. § 1.446-1(a)(4); former Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4) repealer filed June 25, 1981 (Register 81, No. 26).) In the absence of such records, the taxing agency is authorized to compute the taxpayer's income by whatever method will, in its judgment, clearly reflect income. (Rev. & Tax. Code, § 17561, subd. (b).) The existence of unreported income may be demonstrated by any practical method of proof that is available., (Davis v. United States, 226 F.2d 331 (6th

Cir. 1955); Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971.) Mathematical exactness is not required. (Harold 'E. Harbin, 40 T.C. 373, 377 (1963).) Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of proving it erroneous. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

In the instant case, respondent has used a number of different approaches to reconstruct appellant's income. Where actual evidence of amounts received by appellant was available, respondent used that information to reconstruct appellant's income. For example, certain entities with which appellant was involved kept records of the amounts which were paid to appellant or his sole proprietorship and when these records were available, respondent used these entries to reconstruct appellant's income. This method of reconstruction is generally known as the specific item method of proof of income. (See Schmidt, Reconstruction of Income, 19 Tax L. Rev. 277 (1964).) For other entities with which appellant was involved, complete checking account records were available. Where a taxpayer fails to maintain adequate records as to the amount and source of his income, it is well settled that the tax collector may determine that such bank deposits are income to him. (Estate of Mary Mason, 64 T.C. 651 (1975).) This method for computing income is called the bank deposit method and has long been sanctioned by the courts. (See, e.g., Goe v. Commissioner, 198 F.2d 851 (3rd Cir. 1952); Halley Commissioner, 175 F.2d 500 (2nd Cir. 1949).) For still other entities, respondent apparently used a variant of the percentage of sales method to estimate appellant's income from allegedly similar businesses. The essence of this method is that there is a percentage of gain which is common to items sold in a particular kind of business in a particular area which may be applied to similar businesses of the taxpayer to determine his income from that business. (See Schmidt, Reconstruction of Income, supra, 19 Tax L. Rev. at 297, 298.) In addition, where no bank records or specific items of income were available, respondent used the projection method to estimate appellant's income. This method, heretofore utilized by this board in appeals involving drug dealers or other illicit activities, involves the projection of income over a period of time based upon reasonable assumptions. (Appeals of Alfred M. Salas and Betty Lee Reyes, Cal. St. Bd. of Equal., Feb. 28, 1984.) Lastly, in two instances, respondent

relied upon information supplied to it by the Internal Revenue Service to determine appellant's income. It is, of course, well settled that respondent's determination based upon a federal action is presumed to be correct. [redacted] Cal. St. Bd. of old Loan and June 2, 1971.)

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Different theories of proof have been used in civil cases in various combinations concurrently with each other and also consecutively over a period of years. 1/ However, when several theories are utilized, "a doubling-up of income may easily result from a careless audit by the investigating agents, resulting in an improper application of . . . tax principles." (See Schmidt, Reconstruction of Income, supra, 19 Tax L. Rev. at 283.) Accordingly, the focus of our inquiry at this juncture is twofold: (1) has respondent properly reconstructed income using each method noted above; and (2) to the extent it has, has there been any duplication resulting in an improper reconstruction of appellant's total income?

Respondent has determined that during the period at issue, appellant was involved with 39 separate businesses or income-producing activities. Relying upon the methods of proof noted above, and information obtained subsequent to its assessments, respondent substantiated those assessments by reconstructing appellant's income as follows:

1973	$ 414,700
1974	$1,767,896
1975	$1,079,479
1976	$ 665,595
1977	$ 576,618
1978	$ 829,536 2/

1/ See generally discussion in Schmidt, Reconstruction of Income, 19 Tax L. Rev. 277, 281-283 (1964). However, it should be noted that in no case reviewed have so many methods been used concurrently as respondent uses in this appeal.

2/ As can be seen, respondent's reconstruction of appellant's income for this appeal greatly exceeds the original assessments of income as stated on the Notices of Additional Tax Proposed to be Assessed as noted at p. 3 above.

In spite of the fact that, for the most part, appellant has not cooperated in providing accurate records from which his income can be precisely determined, the record submitted to this board by respondent is voluminous. Unfortunately, this record consists basically of primary data with little analysis by respondent and, accordingly, we are required to focus our discussion using some degree of specificity. Before embarking on the journey, it is important to keep in mind those well-settled principles which must guide our inquiry. First, as indicated above, the determination of taxable income by the taxing authority is presumptively correct. (See, e.g., Welch v. Aelvering, 290 U.S. 111 [78 L.Ed. 212) (1933).) When a taxpayer has defaulted in his task of supplying adequate records of his income as the appellant has, he is not in a position to be hypercritical of the tax collector's efforts. (Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968).) However, the absence of adequate tax records does not give the tax collector "carte blanche for imposing Draconian absolutes." (Webb v. Commissioner, supra, 394 F.2d at 373; Gasper v. Commissioner, 225 F.2d 284 (6th Cir. 1955).) Accordingly, where the record shows that the tax collector's determination is arbitrary and excessive, such determination must be set aside. (Gasper v. Commissioner, supra; Durkee v. Commissioner, 162 F.2d 184 (6th Cir. 1947).)

A. PERCENTAGE OF SALES

As indicated above, respondent has used a variation of the percentage of sales method to estimate appellant's income from allegedly similar businesses. Relying upon information from offering materials (e.g., Articles of Limited Partnership and Private Placement Memoranda), respondent determined the total capitalization of various entities and the amount of compensation either as organization fees or management fees, which it felt appellant derived from such activities in order to develop an average ratio of compensation received by apellant with respect to other entities with known capitalizations. The validity of such a method, of course, is dependent upon the evidence available to establish the amount of the ratio (James Ross, ¶ 56,005 P-H Memo. T.C. (1956)) and upon the similarity of the businesses compared. (Schmidt, Reconstruction of Income, supra, 19 Tax. L. Rev. at 299-301.) Respondent used the following data to determine that appellant received 18 percent of the capitalization of entities with which he was involved as compensation:

Name	Capitalization	Compensation	Percentage
Diversified Natural Resources, LTD No. 1 (DNR #1)	$300,000	$75,000	25%
American Mineral Investment Co. (AMICO)	$130,000	$30,000	23.08%
California Mineral Investment Co. (CAMICO)	$130,000	$30,000	23.08%[3/]
Warren Meadows	$150,000	$24,000	16%
Mineral Exploration Company (MEXCO)	$250,000	$50,000	20%
Diversified Natural Resources LTD No. 2 (DNR #2)	$200,000	$30,000	15%
Futures System Company (FSC)	$258,700	$28,400	10.97%
Researched Trading Systems LTD (RTS)	$307,100	$33,200	10.81%
Diversified Mineral Exploration Company (DMECO)	$200,000	$40,000	20%
'77 Investment Assocates	$216,700	$39,400	18.13%

3/ Respondent's chart indicates incorrectly that this number is 16 percent.

Mineral Hill	$338,000	$68,000	20.12%
TOTALS	$2,480,700	$448,000	18.06%

In addition to the development of this ratio as an approximation of appellant's compensation, respondent also concluded that where capitalization'figures were not available, based upon the above-noted compensation figures, a minimum income base of $10,000 was to be used for entities with respect to which respondent has evidence of "business contact" or activity but no actual evidence of income. (Resp. Br. at 13.) Por example, appellant was "listed" as regional vice-president of Chase Capital Corporation (Chase). Since the investment activity and its income were unknown, respondent assumed appellant's income. from Chase to be $10,000 for 1973. Respondent states that if its assumptions-are, in fact, incorrect, appellant is invited to submit an affidavit "stating either noninvolvement with this . . . entity or documentary proof that the income amount asserted against appellant for such activity is less than the amount stated." (Resp. Br. at A-2.)

Respondent used this method (either by applying the 18-percent ratio or the base income concept) to reconstruct appellant's income from the following entities:

	Year	Amount
Surety Drilling	1973	$11,800
Chase Capital Corp.	1973	$10,000
Investment Programs International, Inc.	1973	$10,000
San Jose Agman, Ltd. #1	1973	$18,000
San Jose Agman, Ltd. #2	1973	$18,000
Arboles De Portola, Ltd.	1973	$10,000
Independent Securities Corporation	1973	$10,000
Investogenic Service, Inc.	1973	$10,000
Life Insurance and Real Estate Sales	1973	$20,000

Big Valley Pistachio Grove, No. 1	1973	$10,008
Oklahoma Crude Production Fund	1974	$10,800
Pour Queens Oil Production Fund	1974	$16,740
NAVSAT Systems, Inc.	1975	$37,300
Computer Commodity Systems	1978	$40,000
Investment Research, Inc.	1975	$10,000
Alaska Placer/Mascott Placer	1975	$10,000
Locator Oil and Gas	1975	$10,000
Diversified Mineral Investments	1975	$20,000
T.V. Video Tape	1978	$45,000

We think that to the extent respondent has based its reconstruction of income on this method, its assessment is arbitrary and without authority. Indeed, the root hypothesis on which respondent has based its reconstruction appears to be almost imaginery. (Leonard Cephus Hall, ¶ 53,314 P-H Memo. T.C. (1953).) We base this conclusion on several factors. First, we find that respondent's computations indicating that appellant received 18 percent of the capitalization of entities with which he was involved with known capitalizations to be inaccurate and to be made in a careless manner. Our review of the records indicates that appellant's actual compensation for his services for known entities was as follows:

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	Capitalization	Compensation	Percentage
DNR #1	$300,000	$15,000	5%
AMICO	$130,100	$30,000	23%
CAMICO	$130,100	$30,000	23%
Warren Meadows	$150,000	$24,000	16%
MEXCO	$250,000	$20,375	8.15%

DNR #2	$200,000	$17,950	8.97%
FSC	'$258,700	$28,400	10.97%
RTS	$307,100	$33,200	10.81%
DMECO	$200,000	$20,000	10%
'77 Investment Associates	$216,700	$131133	6.06%
Mineral Hill	$338,000	$46,700	13.81%
TOTALS	$2,480,700	$250,808	10.1%

Accordingly, appellant's actual compensation was approximately ten percent of capitalization rather than 18 percent as respondent computed. Nevertheless, respondent argues that since it may properly determine that a single member of a group engaged in a criminal activity producing income can be charged with the entire income (Appeals of Alfred M. Salas and Betty Lee Reyes, supra), it may properly allocate all compensation (i.e., 18 percent) to appellant and then use this figure to estimate his income from other sources. 4/ The rationale for this position is that the tax collector must protect the collection of "revenue from inconsistent positions that might be maintained by the participants.' (Ronald L. Miller, ¶ 81,249 P-H Memo. T.C. (1981).) However, in this appeal, accurate records have been maintained which indicate actual compensation so that maintenance of inconsistent positions by the participants is highly unlikely. In addition, there is no indication that the other participants did not properly report the compensation which they earned. (Compare Appeals of Alfred M. Salas and Betty Lee Reyes, supra.) Accordingly, respondent's root hypothesis that appellant received 18 percent of capitalization as compensation is arbitrary and computed in such a manner as to be compromised for estimating his income from other sources.

In addition, the validity for using the percentage of sales method depends upon establishing the similarity of businesses compared. In the instant matter, there is no indication that the businesses compared or

4/ As indicated, infra, appellant admits that he engaged in illegal activities.

the compensation derived therefrom which are used to develop the ratio are similar enough to base reconstruction computations. For example, the record indicates that the business of RTS was commodity trading from which appellant received an organizational fee in the inception of business and, in addition, apparently managed to siphon off other "income" by management contracts, kickbacks and churning of accounts. On the other hand, the business of Warren Meadows was the mining of gold and other metals and the only form of compensation for appellant appears to have been derived from the initial organization and management fees. Accordingly, not only are these business endeavors quite different, but the compensation possibilities are very dissimilar. Still, respondent used these entities as integral elements in reconstructing appellant's compensation from the percentage of sales method. To base reconstruction computations on this type of data appears to be arbitrary and imprecise.

Moreover, respondent's use of a minimum income base of $10,000 is even more arbitrary and appears to be based upon speculation. As indicated above, respondent had no information with respect to the business activity or income of Chase and at least 16 other entities with which it used this method. Because of the absence of evidence which would establish the similarity of businesses as is ordinarily required with this method, respondent invites appellant to prove that his income, if any, from these entities is less than the amount which it has reconstructed. Respondent's reconstruction of appellant's income (i.e., "base income") using the method appears to be not only arbitrary and speculative, but based upon the record before us, almost punitive. In essence, the wellspring of respondent's use of this method is its conclusion that appellant is a "bad man"[5/] and, as such, should be subjected to a harsher standard. However, even in Estate of Mary Mason, supra, where the taxpayer had been convicted of arson and was serving a prison term and can clearly be described as a "bad man," the tax court attempted to find a method of reconstruction

5/ The record indicates that four injunctions have been obtained against appellant with respect to various activities, and in one instance appellant pled "nolo contendere" to a criminal violation of the sale of an unregistered security and was fined $500.

of income as fair to the taxpayer as it could in light of the available evidence. 6/

Accordingly, in our attempt to find a method of reconstruction of appellant's income which is fair to him, we find that based upon the paucity of evidence available to us with respect to the percentage of sales method, to the extent that respondent's determination is based upon this method, that determination is arbitrary and excessive and must be set aside.

B. BANK DEPOSIT METHOD

Where a taxpayer has failed to maintain adequate records as to the amount and source of his income, the tax collector may determine that deposits to his bank or checking accounts are income to him. And when such taxpayer offers no plausible explanation of such deposits, the tax collector is not arbitrary or capricious, in resorting to the bank deposit method for reconstructing his income. (Estate of Mary Mason, supra, 64 T.C. at 657; Schmidt, Reconstruction of Income, supra, 19 Tax L. Rev. 288-291.) Ordinarily, after gross receipts have been calculated, it is necessary to deduct all business costs and personal deductions to which the taxpayer is entitled in order to determine taxable income. (R. D. Leeby, ¶ 56,118 P-H Memo. T.C. (1956).) However, some courts have not allowed any deduction from gross receipts calculated from bank deposits. (Martin Cooperberg, ¶ 79,102 P-H Memo. T.C. (1979).) In this appeal, respondent has chosen not to deduct any business costs or personal deductions from gross receipts. 7/ Since appellant has failed to furnish records, he is in no position to be hypercritical of respondent's efforts.

6/ This conclusion does not negate the fact that where a method of reconstruction of income has been properly used based upon the evidence available (e.g., see bank deposit method infra), and the taxpayer presents no evidence to rebut respondent's presumption, "he is not in a position to be hypercritical of [respondent's] . . . labor." (Webb v. Commissioner, supra, at 372.)

7/ While respondent has given no reason why it has not made an attempt to estimate deductions, it appears that its basis for such action was either the fact that appellant did not substantiate his entitlement to any deductions (Appeal of Arthur, Jr., and Daisy M. Bedford, Cal. St. Bd. of Equal., June 29, 1982), or the fact that no deductions were allowable because the income-producing activity was illegal. (Rev. & Tax. Code, § 17297.)

Respondent used this method to reconstruct appellant's income from the following five entities:

	1974	1975	1976	1977
Charles, Scott & Co.	$ --	$347,243	$219,223	$479,801
Western Drilling	877,481	188,000	36,054	--
Western Geo Research	102,000	161,570	9,000	--
Western Mineral Resources	137,000	67,366	7,868	--
South Valley Freeway	--	9,000	--	--
TOTALS	$1,116,481	$773,179	$272,145	$479,801

During the period at issue, appellant was either the sole proprietor or president of each of those entities. Pursuant to the fictitious name filing made in Santa Clara County for Charles, Scott & Company and its bank signature card, appellant was listed as its sole proprietor. In addition, appellant was identified as president of Western Drilling Co., Inc., Western Geo Research, Inc., Western Mineral Resources, and general partner of South Valley Freeway Properties, Ltd., on the respective bank signature cards. No other persons (except for appellant's wife) were authorized to withdraw funds from these accounts. In addition, it appears that appellant did not maintain any of the usual corporate formalities, and in such circumstances, the tax collector is entitled to treat the entity as 'unreal or a sham [and] may . . . disregard the effect of the [corporate] fiction as best serves the purposes of the tax statute." (Higgins v. Smith, 308 U.S. 473, 477 [84 L.Ed. 406] (1940).) Accord-, based on the record before us, respondent's allocation of all bank deposits to appellant as income appears to be-reasonable in light of the record presented to us, and to the extent that its reconstruction is based upon this method, its determination must be sustained.

C. SPECIFIC ITEM METHOD

The third method of reconstruction of income used by respondent is the specific item method which

identifies specific items of income paid to appellant. For example, the financial records for Mineral Hill indicate that appellant was paid $46,700 directly in 1975 through his sole proprietorship Charles, Scott & Co. by Mineral Hill. Accordingly, respondent included this sum in reconstructing appellant's income for that year. Respondent used this method of reconstruction for the following entities:

Diversified Mineral Exploration Company (DMECO)	1974	$ 29,900
American Mineral Investment Co. (AMICO)	1974	$130,000
California Mineral Investment Co. (CAMICO)	1974	$130,000
Mineral Exploration Company (MEXCO)	1974	$ 20,375
Natural Resources Investment Corporation (NRIC)	197s 1976	$ 21,300 $ 2,500
Mineral Hill	197s	$ 46,700
Diversified Natural Resources Ltd. No. 1 (DNR #1)	197s	$ 15,000
Diversified Natural Resources Ltd. No. 2 (DNR #2)	197s' 1976	$ 13,500 $ 4,450
Warren Meadows	1 9 7 6	$ 24,000
Researched Trading Systems Ltd. (RTS)	1976	$182,700
Futures System Company (FSC)	1976	$162,300

'77 Investment Associates	1977	$ 52,817
Del Vida, Inc.	1 9 7 8	$ 16,865

A careful review of the records indicates that respondent's use of specific items to reconstruct appellant's income only duplicated income already accounted for by the bank deposit method. Indeed, income, as reconstructed, received as compensation by appellant from NRIC, Mineral Hill, DNR #1, DNR #2, Warren Meadows, and Del Vida, Inc., can be clearly traced directly to bank deposits which also have been used in reconstructing income received by appellant from other entities. In addition, appellant's sole proprietorship, Charles, Scott, and Co., was the general partner for RTS and any income derived therefrom by appellant (reconstructed at $182,700 for 1976) undoubtedly was included in Charles, Scott & Co.'s bank deposits for that year. Moreover, while the record doesn't permit the same degree of certainty of duplication for the specific items attributed to DMECO (1974: $29,900), AMICO (1974: $130,000), CAMICO (1974: $130,000), and MEXCO (1974: $20,375), Western Drilling Co., Inc., was, in fact, the general partner for each of these entities and the specific items attributed to them were more than accounted for by the bank deposits (i.e., 1974: $877,481) previously attributed to Western Drilling. Accordingly, we find that respondent's use of the specific item method with respect to the above-named entities duplicates income already reconstructed and is therefore arbitrary. While we were not able to find clear-cut evidence of such duplication with respect to FSC and '77 Investment Associates, we must conclude that the entire methodology used by respondent has been compromised by the duplication which we otherwise have found. Therefore, to the extent that respondent's reconstruction of income is based upon this method, that determination must be set aside.

D. BROJECTION METHOD

Respondent also used the projection method to reconstruct appellant's income from Charles, Scott & Co. for years in which the actual bank deposit records were 'not available. That is, as indicated above, actual bank deposit records for Charles, Scott & Co. were available for the following years: 1975, $374,243: 1976, $219,223: and 1977, $479,801. Since no actual records were available for other years, respondent then projected those bank deposits back to 1973 and 1974 and forward to 1978,

using a ten-percent inflation factor both forwards and backwards. These projections resulted in the following figures:

1973	$286,900
1974	$313,600
1978	$527,800

The projection method involves projecting a level of income over a period of time and has been frequently used by this board, although heretofore exclusively in cases involving illegal activities such as drug sales (Appeals of Alfred M. Salas and Betty Lee Reyes, supra) or bookmaking. (Appeal of Theodore Halushack, Cal. St. Bd. of Equal., Nov. 14, 1984.) Because of the difficulty in obtaining evidence in cases involving illegal activities, the courts and this board have recognized that the use of some assumptions must be allowed in cases of this sort. (See, e.g., Shades Ridge Holding Co., Inc., ¶ 64,275 P-H Memo. T.C. (1964), affd. sub nom., Fiorella v. Commissioner., 361 F.2d 326 (5th Cir. 1966); Appeal of Burr MacFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.) It has also been recognized, however, that a dilemma confronts the taxpayer whose income has been reconstructed. Since he bears the burden of proving that the reconstruction is erroneous, the taxpayer is put in the position of having to prove a negative, i.e., that he did not receive the income attributed to him. In order to ensure that use of the projection method does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board have held that each assumption involved in the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973): Shapiro v. Secretary of State, 499 F.2d 527 (D.C. Cir. 1974), affd. sub nom., Commissioner v. Shapiro, 424 U.S. 614 [47 L.Ed.2d 278](1976); Appeal of Burr MacFarland Lyons, supra.) Stated another way, there must be credible evidence in the record which, if accepted as true, would "induce a reasonable belief" that the amount of tax assessed against the taxpayer is due and owing. (United States v Bonaguro, 294 F.Supp. 750, 753 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono, 428 F.2d 204 (2d Cir. 1970).) If such evidence is not forthcoming, the assessment is arbitrary and must be reversed or modified. (Appeal of Burr MacFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

The two major underpinnings of respondent's projections are that appellant was in the business of selling tax shelter or investment products in 1973, 1974, and 1978, and that his bank deposits in 1975, 1976, and 1977 provide an indication of his success in the years for which his income was projected. Both of these assumptions have significant flaws. Respondent bases its assumption that appellant was doing a significant business in 1973 and 1974 upon statements which appellant made to potential investors in his periodic newsletters. For example, one letter on Charles, Scott and Co. letterhead dated December 28, 1974, stated that 1974 "has been the most hectic year we have ever had in tax sheltered investments." (Resp. Br., Ex. M-46.) Respondent concluded that this statement indicated-that appellant enjoyed significant business activity in both 1973 and 1974. However, appellant's letters to his investors are replete with inaccurate statements and exaggerations designed only as sales promotions. To deduce that such' fallacious statements have any evidentiary value appears to us to be unreasonable. More significantly, respondent's assumption that bank deposits in 1975, 1976, and 1977 can be projected to 1973, 1974, and 1978, by using a ten-percent inflation factor is inconsistent with the data in the record. Respondent's assumption of using a ten-percentinflation factor is based upon the belief of an orderly or even rate of growth in appellant's business activities. However, a review of Western Drilling's business disproves this assumption. Western Drilling's bank deposits amounted to $877,481 in 1974, $188,00 in 1975, and only $36,054 in 1976. Clearly, appellant's business activity did not lend itself to orderly growth or easy projections and, since no other facts have been presented to us, basing projections on such bank deposits as are known is arbitrary and unreasonable.

Accordingly, based on the record before us, we find that respondent's use of the projection method is unreasonable, and to the extent that its determination is based upon this method, it is arbitrary and excessive and must be set aside.

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E. FEDERAL DETERMINATION

Lastly, respondent relied upon information supplied by the Internal Revenue Service to determine that appellant received $44,000 in income from Del Vida, Inc., in 1977 and $199,871 in income from Western Financial

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Management in 1978.[8] As appellant has not provided us with any rebuttal, we have no choice but to find that to the extent respondent's determination is based upon these items, it is reasonable. (Appeals of Lawrence S. and Joy A. Ames, supra.)

As indicated above, appellant has presented no evidence to rebut respondent's reconstruction of his income. Instead, he merely argues he is unable to establish that he had no income without incriminating himself in violation of the Fifth Amendment of the United States Constitution. We believe, however, that the adoption of Proposition 5 by the voters on June 6, 1978, adding Section 3.5 to article III of the California Constitution, precludes our determining that question. Moreover, this board has a well-established policy of abstaining from deciding constitutional questions in appeals involving deficiency assessments. (Appeal of Leon C. Harwood, Cal. St. Ed. of Equal., Dec. 5, 1978; Appeal of Iris E. Clark, Cal. St. Bd. of Equal., March 8, 1976.) However, even in cases in which such constitutional questions have been considered, it has been held that the Fifth Amendment privilege does not relieve appellant of his burden of proof. (Roger D. Wilkinson, 71 T.C. 633 (1979): Lonnie Lee Stradling, ¶ 81,173 P-H Memo. T.C. (1981).)

Based on the above review, we conclude that there is sufficient evidence in the record to support the following reconstruction of income:

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	Bank Deposit Method	Federal Determination	Total Reconstruction
1973	$ --	$ --	$ --
1974	1,116,481	--	1,116,481
1975	773,179	--	773,179
1976	272,145	--	272,145
1977	479,801	44,000	523,801
1978	--	199,871	199,871

This is enough to sustain respondent's reconstruction of appellant's income on the original assessments

8/ Respondent bases its reconstruction of income for Western Financial Management upon gross receipts rather than net receipts or taxable income, apparently relying upon the same rationale as discussed above in footnote 7.

for 1974, 1975, 1976, and 1977, but its reconstruction for 1973 must be reversed and for 1978, modified. Moreover, with respect to the penalties at issue, it is well settled that the taxpayer has the burden of showing that their imposition was improper. (Appeal of Thomas T. Crittenden, Cal. St. Bd. of Equal., Oct. 7, 1974.) Since appellant has introduced no evidence regarding the propriety of such penalties, we have no choice but to sustain their imposition for the years and amounts for which appellant's income has been properly reconstructed.

O RD E.R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Charles R. Rietz against proposed assessments of additional personal income tax and penalties in the total amounts of $31,815, $32,887.50, $55,616.25, $38,168.16, $31,772.59, and $35,958.75 for the years 1973, 1974, 1975, 1976, 1977, and 1978, respectively, be and the same is hereby modified in accordance with this opinion. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 9th day of April , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr. , Chairman

Conway H. Collis , Member

Richard Nevins , Member

Walter Harvey* , Member

, Member

*For Kenneth Cory, per Government Code section 7.9

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81A-1206-GO
CHARLES R. RIETZ)

ORDER DENYING PETITION FOR REHEARING

AND MODIFYING OPINION

Upon consideration of the petition and supplement filed April 23, 1985, and June 24, 1985, respectively, by the Franchise Tax Board for rehearing of the appeal of Charles R. Rietz, we are of the opinion that none of the grounds set forth in the petition constitutes cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of April 9, 1985, be and the same is hereby affirmed.

Good cause appearing therefore, it is also hereby ordered that our opinion of April 9, 1985, be and the same is hereby modified as follows:

1. On page 5, line 2, delete the sentence commencing, "It is, of course, ..." and the accompanying citation.

2. On page 9, line 25, delete "and to be made in a careless manner".

3. On page 17, delete the heading and first paragraph of part E. and substitute the following;

"E. FEDERAL INFORMATION"

"Lastly, respondent relied upon information supplied by the Internal Revenue Service to determine that appellant received $44,000 and $16,865 in income from Del Vida, Inc., inn 1977 and 1978, respectively, and

$199,871 in income from Western financial Mangement in 1978.[8/] As appellant has not provided us with any rebuttal, we find that to the extent respondent's determination is based upon these items it is reasonable,"

4. On page 18 replace the table with the following:

	Bank Deposit Method	Federal Information	Total Reconstruction
1973	$ --	$ --	$ --
1974	1,116,481	--	1,116,481
1975	773,179	--	773,179
1976	272,145	--	272,145
1977	479,801	44,000	523,801
1978	--	216,736	216,736

Done at Sacramento, California, this 6th day of January, 1986; by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9